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Viewing cable 06QUITO1920, PETROECUADOR - A CRUMBLING GIANT

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Understanding cables
Every cable message consists of three parts:

- The top box shows each cables unique reference number, when and by whom it originally was sent, and what its initial classification was.
- The middle box contains the header information that is associated with the cable. It includes information about the receiver(s) as well as a general subject.
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If you find meaningful or important information in a cable, please link directly to its unique reference number. Linking to a specific paragraph in the body of a cable is also possible by copying the appropriate link (to be found at theparagraph symbol). Please mark messages for social networking services like Twitter with the hash tags **#cablegate** and a hash containing the reference ID e.g. **#06QUITO1920**.

Reference ID	Created	Released	Classification	Origin
06QUITO1920	2006-08-03 22:45	2011-08-30 01:44	CONFIDENTIAL//NOFORN	Embassy Quito

Appears in these articles:
http://m.elcomercio.com/wikileaks/cable.php?c=642e92e

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VZCZCXYZ0009
OO RUEHWEB

DE RUEHQT #1920/01 2152245
ZNY CCCCC ZZH
O 032245Z AUG 06
FM AMEMBASSY QUITO
TO RUEHC/SECSTATE WASHDC IMMEDIATE 4985
INFO RUEHBO/AMEMBASSY BOGOTA PRIORITY 5854
RUEHCV/AMEMBASSY CARACAS PRIORITY 1913
RUEHLP/AMEMBASSY LA PAZ AUG 9992
RUEHPE/AMEMBASSY LIMA PRIORITY 0832
RUEHGL/AMCONSUL GUAYAQUIL PRIORITY 0937
RHMFISS/DEPT OF ENERGY WASHINGTON DC PRIORITY
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY

C O N F I D E N T I A L QUITO 001920

SIPDIS

SENSITIVE
SIPDIS

TREASURY FOR SGOOCH

E.O. 12958: DECL: 08/03/2016
TAGS: ECON
SUBJECT: PETROECUADOR - A CRUMBLING GIANT

REF: A. QUITO 4525-91

     ¶B. QUITO 1735
     ¶C. QUITO 1905-03
     ¶D. QUITO 0579
     ¶E. QUITO 1973-91

Classified By: EconOff Sara Ainsworth for reasons 1.4 (b&d)
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¶1. (C) Summary. Petroecuador, Ecuador's state-owned oil company, has sole responsibility over the country's most lucrative resource, yet is suffering from a severe financial crisis, a steady decline in production, and a terribly inefficient and inadequate refining capacity. Graft permeates all levels of its cumbersome bureaucracy, and the company's union tends to reward its most unproductive personnel.

Its equipment and production technologies are woefully outdated, yet under-investment and forced oil subsidies to consumers cripple the company's budget. President Palacio submitted a proposal to Congress on May 17 that addresses some of these problems but falls short of a much-needed overhaul, and which anyway will likely languish in Congress in the run-up to the election.

Reforming Petroecuador in any meaningful way will be an uphill battle; pumping more money into the company will not cure its ills. Even as the company becomes more inefficient and production continues to decline, Petroecuador continues to be a magnet for political elites that are motivated by manifold opportunities for graft and patronage. Consequently there is an absence of political will to get the job done. End summary.

Productivity A Rolling Stone

¶2. (U) Oil is Ecuador's most important export, constituting 60% of total exports in the first quarter, and projected to bring in close to $3 billion for the state in crude revenues, and another $500 million in corporate taxes from the industry. Petroecuador, the state energy company, has annual sales of more than $5.5 billion, and on its own accounts for 16 percent of Ecuador's GDP. Last year, the company generated $2.3 billion for the treasury, representing 40% of the total national budget.

Despite record petroleum prices, Petroecuador is suffering from a severe financial crisis, a steady decline in production, and a terribly ineff
Finally, industry service providers are wary of working with the company due to its abominable payment record and questionable business practices.

¶3. (U) Petroecuador has changed little since its inception in 1989. Industry contacts told EconOff that Petroecuador's performance has spiraled downward in the last ten years due to corruption, nepotism, lack of transparency, financial hardship, and slow bureaucracy (reftel A). In 1992, the company produced about 120 million barrels per year; today it produces about 71.5 million barrels per year, implying an annual loss of almost $2.5 billion.

Natural well deterioration accounts for some of this loss, but increased politicization, manipulation of the company's revenues, lack of capital investment and exploration, and poor management practices have amplified inefficiencies and financial hardship. Private oil companies have meanwhile taken the lead in Ecuador's oil industry, producing about 20 million barrels per year starting in 1994 and 120 million barrels per year today.

Fossilized Structure

¶4. (U) Petroecuador's architects modeled it after Venezuela's state energy company, PDVSA, which began as an agglomeration of several companies each with its own corporate culture and independent operations. Petroecuador was started from the ground up, and the Government of Ecuador (GOE) partitioned its production chain into three functional arms: Petroproduccion, in charge of exploration, extraction and crude production; Petroindustrial, responsible for refining; and Petrocomercial, which manages transportation of crude oil and local sales of oil derivatives.

It is at once a partner, contractor, regulator and producer, and in each of its guises subject to political influence from the central government. Petroecuador's schizophrenic mandate discourages cooperation and triples bureaucratic procedures.

Each subsidiary maintains its own human resource, legal and administrative functions, duplicating efforts and increasing inefficiencies and bot

¶5. (U) Petroecuador's strict legal structure stifles good business practices necessary for smooth functioning in the global energy sector. Its endless procedures and approvals processes are a major departure from the decentralized nature of most oil companies. Industry contacts told EconOff that Petroecuador personnel are known for their indecisiveness and untimely decisions; "final" decisions are almost always referred to another colleague for approval.

Stone-Age Technology

¶6. (U) Petroecuador has grossly underinvested in its fields and facilities since its inception. According to Petroecuador's published budget for 2005, it spent $178 million on investment, while foreign operating companies in Ecuador invested a total of $1.7 billion. Most of Petroecuador's current infrastructure is now obsolete. Petroproduccion geologists would regularly complain during industry roundtables about the company's lack of technology and resources for maintenance and new wells; 240 of its 800 wells were closed due to a lack of funds. Its warehouses are empty; the company often re-uses valves and reportedly pulls up old tubing to use in new wells. Petroproduccion's pumps are more than twenty-years-old and its valves are used for more than a decade. The industry standard use for both is four years.

¶7. (U) Ten years ago Petroecuador lost its authority to develop and administer an independent budget. Red tape and government bureaucracy also inhibit Petroecuador's budget execution and contribute to its declining operating budget, which must be approved by Ecuador's equally inefficient Congress. As a result, Petroproduccion now owes its suppliers more than $80 million in back payments.

¶8. (U) Government subsidies for refined crude products, which are covered using Petroecuador's proceeds from crude exports, will reduce its resources by more than $1.1 billion this year. Petroecuador sells a $10 tank of butane for $1.60, and a gallon of diesel for less than half its import price. Outstanding debts to Petrocomercial of $450 million from electricity generators, the largest beneficiaries of subsidized fuel, also reduces Petroecuador's budget (reftel B).

Ramshackle Refineries

¶9. (C) Petroindustrial runs Ecuador's three oil refineries, which have a combined capacity of 176,000 bpd. The largest, Esmeraldas, was built in 1975 and refines just over 100,000 bpd. Japanese technology was used for the original design and subsequent upgrade in 1980, and it was renovated again in 1993 using Spanish technology. Former Minister of Energy Fernando Santos told EconOff that the refinery is inefficient and poorly maintained; he compared it to a Japanese car upgraded with German parts. He said that of its 2,500 employees, 2,000 lack the required skills, and that Esmeraldas could run with as few as 600 employees. The IMF has long advocated a full-fledged audit of the Esmeraldas refinery, and in 2003 estimated that Petroecuador could save $300-500 million by shutting it down and importing oil derivatives.

¶10. (C) Domestic consumption of diesel, gasoline and other refined products outstrips refining capacity, and imports will reach $1.8 billion this year. Previous upgrades to the three facilities to enable heavy crude processing have had a limited effect on capacity and have not improved refinement processes. Private investors have no incentive to invest under the GOE's current subsidization policies. The GOE has proposed reinvesting revenues from Block 15, until recently managed by Occidental Petroleum (Oxy), into Petroecuador's refineries. However, as required under Ecuadorian law, the GOE would first need to conduct feasibility studies for building or upgrading refinement capacity, and a legally-mandated tender would take years to secure under government contracting regulations. In the most optimistic case, a new refinery would not be completed until 2013.

Industry contacts tell us that investment is unlikely to improve current operations; Santos likened investment into Esmeraldas to dumping money into a hole in the ground.

Transparent As Mud

¶11. (C) Petroecuador's structure and lack of financial accountability make corruption endemic. On the financial side, each of the various subsidiaries is not responsible for its spending practices. Petroproduccion, for example, has no consolidated debt and keeps no accounts receivables figures. Santos told EconOff that each of Petroecuador's subsidiaries has its own "mafia", and kickbacks for contracts are a regular practice.

Three years ago Petroecuador reportedly tried to contract a company to supply tubing for a well but were unable to locate a company willing to allegedly control the assignment of contracts issued by Petroecuador in return for "commissions" paid before contracts are announced. Industry contacts allege the typical practice for Petroecuador's president is "to pilfer the company and get out".

Over the years, Petroecuador personnel have been implicated in smuggling rings that extorted more than $100 million annually in government oil,

Sindicato Stonewalling

¶12. (SBU) Industry sources have told us that Petroecuador's labor unions control major decisionmaking within the company. Workers engage in strikes or slowdowns on a regular basis in order to demand greater benefits or block changes. Many suggest Petroecuador's unions were key in recent government decisions to expel Oxy and to squash the PDVSA-Petroecuador deal to refine crude. Union members went on strike in March, for example, shutting down production at five key Petroecuador production facilities to demand the expulsion of Oxy and to extract federal funds from the GOE (reftel D).

¶13. (SBU) Efforts to reduce the unions' strength have failed. Of the 33 Petroecuador workers dismissed in 2003 for sabotage and terrorism, 27 were reinstated and returned to their posts after the Ecuadorian Supreme Court ruled in their favor. Each worker received almost $20,000 in compensation. New Petroecuador President and former Minister of Labor Galo Chiriboga has long ties with organized labor, and most insiders expect that he will continue to cede to union demands.

Petrified Personnel

¶14. (U) Petroecuador has long had a reputation for hiring incompetent employees out of nepotism and for political reasons (reftel E). In the last sixteen years, Ecuadorian presidents have appointed twenty heads of Petroecuador. Many have had little or no experience in the oil industry; former president Fernando Gonzalez, appointed last April, was a lawyer and a vocal proponent for the cancellation of Oxy's contract. Petroproduccion Vice-President Jaime Crow has experience in the downstream business but little background in his subsidiary's primary exploration and production functions.

¶15. (U) Lower-level technical staff within Petroecuador are paid significantly less than employees of private companies. Petroecuador's most talented employees often leave to pursue higher-paying jobs with private energy companies. A Petroecuador employee cannot expect a clear career progression within the company. Each change of senior management in all three subsidiaries results in significant turnover and politicization. Promotions and preferences are based on employees' ties to the current power brokers.

All of this cripples employee efficiency. While Oxy produced 100,000 bpd with 318 employees, Petroproduccion produces 190,000 bpd with 1,500 workers, suggesting that each of Oxy's employees is three-times more efficient.

Comment

¶16. (U) On May 17 President Palacio submitted a proposal to Congress that would resolve some of Petroecuador's problems but which falls short of a total overhaul, and which will likely languish in Congress during the run-up to the coming elections. Under Palacio's proposal, one of five members of Petroecuador's Board of Directors would be elected by technical experts, Petroecuador's president would be required to have at least fifteen years of industry experience, and nepotism and conflicts-of-interest in board appointments and the presidency would be forbidden. The proposal would create planning, audit and administrative functions at the parent-company level, develop a human resource management system, enact contracting laws that include at least three offers, and mandate a yearly external audit by an independent international accounting firm. The proposal would allow Petroecuador to issue bonds to increase its financial resources, deduct its costs and investment budget.

¶17. (C) Although the proposal attempts to address some of the company's inefficiencies, privatization would still be the best solution to instill a culture of accountability and efficiency within Petroecuador, but this is politically unpalatable. Attempts during the Sixto Duran administration to adopt privatization were met with staunch opposition by the oil labor unions, which successfully convinced the populace that privatization was a scheme to line the pockets of an already wealthy handful of Ecuadorian businessmen.

¶18. (C) Reforming the state company in any meaningful way will be an uphill battle, and will require more than pouring money into Petroecuador or assigning it a robust budget. Increasing transparency, instituting independent audits and oversight, separating Petroecuador's budget from central government resources, injecting private capital and accountability, and increasing and enforcing regulations are some useful prescriptions. Cultivating an awareness of Petroecuador's corruption in the Ecuadorian public and encouraging the public to demand accountability from the steward of its country's most valuable natural resource might be helpful in pushing politicians to reform the system. Presidential buy-in for reforms is important but not enough. Two years ago, former President Gutierrez purged Petroecuador and demanded reforms to combat corruption, but his tenure in

office was short-lived. Ecuador's revolving door presidency, and congress's ability to block change, makes pushing reforms more difficult.

¶19. (C) Even as Petroecuador becomes more inefficient and production continues to decline, political elites continue to find opportunities for graft and patronage. They strongly support a powerful state role in Petroecuador and are unlikely to support a move toward privatization. Despite a growing public recognition of the company's ineptitude, as evinced by the recent public outcry when Ecuador's Social Security system began investing in Petroecuador, there is an absence of political will to cure what afflicts Ecuador's wealthiest corporate citizen. End comment.
BROWN